"Blue Sky" Laws

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Purpose of "Blue Sky" Laws

THE suggestion of a paper on "blue sky" laws is timely, although difficult to execute. "This law," as Bank Commissioner Dolley, of Kansas, stated in his 1912 report, "is something entirely new in the business world." The general evil, however, at which it is directed—fraud in the sale of property rights—is as old as the institution of private property. This evil has been facilitated and supplemented by the creation and use of corporations; supplemented in the sense that in addition to fraud we have reckless and improvident flotations—"a constant flow of capital into enterprises doomed in their inception" —and also facilities of corporate over-reaching unknown to the common law.[2]

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[2] The following introduction to Finlason's *Report of the case of Twycross* v. *Grant*, published in London in 1877, might well serve as a standing introduction to articles on this subject:

"When, half a century ago, the principle of association was largely applied to commercial enterprises, it became, as all good things are liable to be, grossly and lamentably abused, and the first fault was in excess. In the year 1824–25 two hundred and seventy six companies were projected, of which the aggregate capital, on paper, was £174,114,000. 'However absurd,' observes the historian, 'many of these schemes, the shares of some rose to enormous premiums, especially the foreign mines.' The cause of this excess, however, as the historian mentions, was a spirit of over-speculation, caused by redundancy of capital. People had so much money that they did not know what to do with it, and so they fell an easy prey to artful schemes. The immense multiplication of joint-stock schemes, many of them delusive, in which vast sums of money were lost, lead in 1826 to the most tremendous revulsion in our commerce which threatened the entire country with bankruptcy. In the session of that year, Alderman Waithman brought the subject forward in the House of Commons. The alderman stated that within three years six hundred companies had been formed—most of them for dishonest purposes. 'The directors of these fraudulent schemes worked with the market as they pleased, forcing up the prices of shares to sell, depressing them to buy and pocketing the difference.' . . . Not only were no measures taken against the evil, but the measures taken were such as tended to increase it. The legislation on the subject was marked with singular fatuity. Not only did it afford every facility for the formation of companies, in affording an easy process for incorporation by mere registration, but it really afforded every facility for the formation of fraudulent companies, and took no guarantees for honesty of intention, for the stability of the projectors or the genuineness of the scheme. . . . It seems incredible, but such was the fatuity of a 'reformed' Parliament in dealing with such subjects, that the Joint Stock Companies Act positively allowed a company to be formed, registered and incorporated by the mere subscription of seven persons for a single share each. Of course, the result was that fraud, which this fatuous legislation may almost be deemed to have suggested, was largely practiced, and for the last thirty years innumerable companies have been thus formed, by a few interested schemers, with the design of risking other people's money, not in real and honest enterprise, but in a sordid traffic in shares."

The perspective afforded by a study of this problem in England, France and Germany, is of the greatest value. Much material of this character, including an interesting review of the

It is largely to these corporate possibilities of waste and of effectual but legal "theft" that "blue sky" laws are directed; they would prevent not only fraud but also whatever will, in the language of the acts, "work a fraud" on the unsuspecting purchaser. He must, in the opinion of the Securities Commission of Minnesota, "have a fair chance to gain by his investment." It is not necessarily a "fraud" to sell a man property without disclosing known defects. The doctrine of *caveat emptor* applies. But it may "work a fraud" upon him to sell him stock in a company whose chief asset is an option on a mining lease for which the promoter has received half the stock issue, even when, according to one view, this fact is disclosed. To promote this combination of evils the legislatures of forty-eight states, more or less, have been vying with each other in the sale of corporate facilities, and now to restrain this combination of evils the legislatures of forty-eight states have been urged to set up a machinery to control, not the creation of corporations, but the distribution within each state of corporate securities. Some twenty-eight states, including Ohio, Illinois, Michigan, Wisconsin and Minnesota, have yielded to this demand. Some of the largest and wealthiest states, New York, Pennsylvania, Massachusetts, Indiana, Washington (by a referendum) and Colorado, have resisted this demand.

ORIGIN OF "BLUE SKY" LEGISLATION

In the year 1910, Bank Commissioner Dolley, of Kansas, former chairman of the Republican State Committee, a prosperous merchant and president of a local savings bank, inaugurated a remarkably effective newspaper agitation against "blue sky merchants" in that state. He became imbued with the laudable purpose, not only of driving these "get-rich-quick vultures" out of business, but also of organizing his department to serve the people in investment matters. "I am sure," he wrote in one of his circular newspaper letters, "we can give them some valuable advice and be of much assistance to them in investing their money where it will not be lost." In the same letter he promised "to remove these financial cancers entirely from our state—with the proper help from the legislature." The legislature complied promptly and, without adequate investigation of the subject, enacted the 1911 Kansas Act. Mr. Dolley's advertising genius again

adoption and operation of the 1911 Kansas Act, will be found in a volume entitled *Company Capitalization Control* prepared in 1913 for the State Department of Canada by Thomas Mulvey, author of an annotated *Dominion Company Law* (1919). The responsibility of the state for much of the evil incident to corporate promotion was very recently emphasized by Judge Landis, of the federal court, in Chicago. In sentencing a promoter to ten years' imprisonment he is reported to have said: "The state of Delaware would face an indictment for licensing such corporations as the Pan Motor Company if I could summon a sovereign state into court." The student might read on this subject the address of Edgar H. Farrar of New Orleans, an ex-president of the American Bar Association, in the 1911 Proceedings of that body, also the several addresses of ex-Attorney General Wickersham on anti-trust legislation, and articles entitled *American Democracy and Corporate Reform,* in the *Atlantic Monthly* of January, 1909, and February, 1914. It is interesting to note that West Virginia and Arizona were among the first states to adopt "blue sky" laws, applying not to corporations organized in the state, but only to corporations and others selling securities in the state.

asserted itself. In his 1912 report he was able to say: "The law is rapidly gaining fame all over the civilized world, and I believe that a large number of the states will adopt similar laws at the coming sessions of their legislatures. *I believe that a movement has been started that will eventually result in the regulation and supervision of all kinds of companies in the same manner as banks are now regulated and supervised.*"

The legislatures of fourteen other states "obeyed the impulse" propagated by Mr. Dolley. Several of them adopted his 1911 act without change; others committed, independently, equal follies. Mr. Dolley himself went out of office, and the 1913 Kansas legislature materially amended his act, taking, among other changes, its exclusive administration out of the hands of the bank commissioner. In 1915 the entire act was repealed and a new "speculative securities" act was passed.

THE KANSAS ACT OF 1913

It would be impossible to analyze intelligently and briefly the early 1913 statutes. It is sufficient to say that the Kansas, and similar acts, prohibited the offer or sale of any security (with a few exceptions) without a permit from the state based upon the findings of a state official. These findings must certify that the "proposed plan of business and proposed contracts contain and provide for a fair, just and equitable plan for the transaction of business, and, in his judgment, *promises a fair return* on the stocks, bonds and other securities offered for sale by it." It is quite evident from the language used that the original draftsman either knew nothing of the normal investment security business, or was unaware that both it and the ordinary borrowing of a private business concern were included in his primary prohibition hence subject to the regulatory provisions of the act. The whole conception of the law was that of a typical promotion enterprise by the issuing company. These acts were hopelessly crude and unworkable; they covered an administrative field which could not have been covered in operation by several hundred trained employes; little effort was made to enforce them according to their terms, although they proved effective in several states as a club to frighten "blue sky merchants" out of the state, and to some extent made conservative outside dealers withdraw from the state. Heavy losses resulted in some cases. They were (as are the present laws) capable of serious and corrupt abuse, and they were held unconstitutional in three federal court decisions concurred in by eight judges. (*Alabama Transportation Co.* v. *Doyle*, 210 Feb. 173; *Compton* v. *Allen*, 216, Fed. 537; *Bracey* v. *Darst*, 218 Fed. 482). Most of these laws have been either repealed, materially amended or have become obsolete.

In their inception, these laws were an instance of the "rapid action" by which, as Bagehot says, "excellent people fancy they can do much—that they will most benefit the world when they relieve their own feelings; that as soon as an evil is seen something must be done to stay and prevent it." Since 1915 the development of "blue sky" laws has been characterized by "animated moderation," which the same writer praises as a special virtue of "government by discussion." Some

of the lengthy "blue sky" history of 1913 to 1915 is given in the note.[3]

[3] It seems necessary to mention the litigation and court decisions, in which the writer, as counsel for the Investment Bankers Association of America, had a professional interest. The Investment Bankers Association of America owed its origin, in part, to a desire among reputable dealers in securities to attack and diminish fraud in their distribution. One of its prime movers, Mr. Warren B. Hayden, of Cleveland, later president of the Association, addressed the first convention on "Blue Sky Legislation," and his address, published in the 1912 Annual of the Association and widely commended, may be said to represent the viewpoint with which the Association approached the subject. The Association formulated, and in 1913–14 urged a proposal along the lines of Mr. Hayden's suggestions. A measure embodying these suggestions became the Maine Act of 1913, and in 1917 New Hampshire followed with a similar act. The 1913 Iowa and Michigan acts, representing crude efforts to improve on the Kansas law, contained specific penal provisions which made it unsafe to ignore them. Counsel advised the Association that these acts were, in their opinion, unconstitutional. Suits were commenced to contest the acts, and the result was that the reported decisions held them unconstitutional. These decisions were followed by the federal court decision, which held invalid the West Virginia 1913 Act, which was based on the 1911 Kansas Act. No appeals were taken from these decisions. "Blue sky" agitation of the extreme type seemed to be declining. In 1914 following a general "blue sky" discussion, the first if not the only such discussion ever held by a national association, a committee was appointed by the National Association of Supervisors of State Banks to coöperate with "the so-called investment bankers" in the effort to formulate an effective law. This committee reported in 1915 a "fraud act" based on the fraud section of the federal postal laws, and containing a section requiring notice to a state official of any proposed general offering, and also a section giving complete power of official investigation and prosecution. A copy of this proposal, with the committee report, is found in the 1915 *Proceedings of the National Association of Supervisors of State Banks,* and also in the 1915 *Annual of the Investment Bankers Association of America.* The fraud section and the investigation section constitute the 1916 Virginia Act, but, probably because of the omission of the essential publicity section, the Virginia legislature in 1918 supplemented the fraud act by a 1915 Kansas type of act. The fraud section of this proposal is found in the 1915 West Virginia and 1917 Minnesota acts. Another 1914 committee, that of the Attorneys General Association, of which the Attorney General of Michigan was the chairman, was not willing to have the problem settled by "government by discussion." The committee practically refused its coöperation and drafted a new proposed act which, without time or opportunity for discussion, was at once adopted in Michigan, Arkansas and South Dakota. This measure marked a distinct advance over the previous Michigan Act on which it was based. Its constitutionality was questioned and attacked, and subsequently two federal court decisions held it invalid. (*Halsey* v. *Merrick,* 228 Fed. 805; *Sioux Falls Co.* v. *Caldwell,* 230 Fed. 236.) Both cases were appealed and the Michigan and South Dakota acts were finally sustained by the United States Supreme Court.

The Ohio Act, which stands alone in its form and in most of its detail, was also held unconstitutional in the lower federal court on the authority of the earlier cases (230 Fed. 233), but was finally upheld by the supreme court. These three cases, involving the statutes of Ohio, Michigan and South Dakota, were argued and decided together (242 U. S. 539, 559 and 568) in the supreme court. The Michigan case was brought as a test suit, but, perhaps unfortunately, it reached the highest court in the company of two cases involving more or less typical "blue sky" evils. The result was a legal triumph for the attorney general of Michigan, reversing as it did the practically unanimous decisions in six lower court cases, and the generally accepted view that the principle of administrative control was unconstitutional. The three decisions must be read together. Although it can and should be said that the court does not seem to have thought it necessary to meet or discuss all the specific objections to these acts, it is clear that it decided that (1) the issuance of securities, (2) the business of dealing in securities, and (3) the general flotation or sale of a particular issue or block of securities may, *without violating the federal Constitution,* be made a subject of executive license and control. In commenting on some of the stronger general objections to the acts, Mr.

PRESENT "BLUE SKY" LAWS

The breathing spell and check given by the decisions holding the earlier laws invalid has been followed by the enactment of new statutes, eliminating the more obvious crudities of the earlier laws but in the main adhering to the original principle of executive control. It is not feasible to present the details of specific acts, but we can perhaps outline what may be called the prevailing type of a regulative law,[4] the constitutionality of which has been sustained by the supreme court.

Justice McKenna disclaimed any judicial responsibility for their wisdom saying, "we cannot stay the hands of government upon a consideration of the impolicy of its legislation. It costs something to be governed."

[4]The existing laws vary greatly. The 1915 Kansas Act is found in modified form in North Dakota (1915), Virginia (1918), Oklahoma (1919) and Wyoming (1919). It accepts the general suggestion, originally made by the Investment Bankers Association, of dealing distinctively with "speculative securities," but the term is so broadly defined that it is hardly safe to assume that any security (not specifically exempted) is excluded. The West Virginia 1915 Act also rests primarily on "speculative securities." This act was copied from a pamphlet circulated by the former corporation commissioner of Oregon, and was enacted in West Virginia apparently without the benefit of changes made by its proponent before it was introduced in the Oregon legislature, which body incidentally rejected the whole proposal. The Michigan 1915 Act mentioned in the preceding note is found in modified form in Arkansas (1915), South Dakota (1915) and South Carolina (1915). It was used as a basis for the Minnesota 1917 Act, but with many improvements. All of the other acts proceed on more or less independent lines. Those of Maine (1913) and New Hampshire (1917) are mentioned in the preceding note. The form and phraseology of the first Kansas Act may still be found to some extent in the laws of Idaho, Arizona, Montana, Tennessee, Missouri and Vermont. The last two acts contain discretionary exemptions which have made them relatively harmless against legitimate business. The Idaho Act is almost identical with the 1911 Kansas Act.

PREVAILING TYPE OF "BLUE SKY" LAW

The law prohibits the offering or sale of securities, with certain exemptions, except under the conditions prescribed by it. A violation is punishable, and may also have the effect of making a sale illegal, with a resulting suit for recovery of the purchase price (*Edwards* v. *Ioor*, 205 Mich. 617), and possibly for the recovery of damages against all parties concerned. The dealer in securities must secure an annual license, the granting of which is discretionary and revocable. This requires a fee and a large amount of detailed information, most of which, it may be assumed, is never read by the state official if he knows that the dealer is a recognized financial house. This law applies to all issuers of and dealers in securities. A non-resident issuer or dealer having no office in the state is an issuer or dealer under the law if he offers or sells securities in the state.

Before offering a particular security in a "blue sky" state the issuer or dealer must determine whether the law applies to that security. Certain kinds of sales, such as sales by the owner not in the course of repeated transactions, sales to a bank or dealer and new stock issues to existing stockholders, are exempt. Certain classes of securities are also exempt, including governmental and municipal bonds, approved public utility securities and securities senior thereto; securities listed and dealt in on approved exchanges or regularly quoted in newspapers for a year, and securities senior thereto; also certain classes of local

securities, such as bank stocks, commercial paper and first mortgage bonds or real estate in the state. Manifestly many sound and necessary investment offerings are not included in these exemptions.

If the security is subject to the law, the application for leave to offer it must be accompanied by a fee based on the amount proposed to be offered in the state. Detailed information as to the issuing company, its character, powers, properties, stock issues and business, is required to be furnished. A state official must be designated for service of process on the applicant in any future suit. Additional information may be required either in the first instance or from time to time. Appraisals and audits may be required, or an official investigation of properties made, without limit as to expense, but *all at the expense of the applicant.* The Securities Commission must examine the information furnished. Presumably it must continue its examination until it is satisfied that the proposed sale will not "constitute a fraud," or "work a fraud" on the purchaser. It then issues a permit or license under which the securities in a named amount may be sold within the state. It is possible and usual in proper cases for it to condition the permit. This it may do indirectly by requiring the applicant to file a statement that the securities are to be sold under certain conditions, for instance, at not exceeding a named price. The law also empowers the commission to require the cancellation of any stock issued for property in excess of what it considers a fair value, and to require a deposit in escrow of any promoters' stock, to prevent its being sold prior to the fulfilment of prescribed conditions, or the demonstration of earning power over a given period. The permit to sell, like the dealer's general license, may be revoked for cause. It is required to be revoked if the licensee at any time refuses desired information, or refuses to sanction an expert investigation of his business or properties (possibly in Peru) at its own expense.[5] Appeals may be taken to the courts to compel

[5] A state official, very prominently identified with the development of these laws, once remarked that "the difficulty of approving an issue on a South American property did not bother them." They had in fact just had such a case. They couldn't examine the property, of course, but they made the promoter give a bond securing investors in the state against loss. He added: "He was a good fellow; he gave the bond but I don't believe he tried to sell any of the stock." It is difficult for anyone with a national viewpoint of the subject to grasp the intelligent local viewpoint of this instance. It meant of course the practical cessation of this presumably legitimate offering in that state. A most complete and persuasive statement of the purpose and operation of the present laws is found in the 1918 report of the Minnesota Securities Commission. The following extract is illuminating:

"The purpose of the law as stated in the preamble is to prevent fraud in the sale and disposition of stocks, bonds or other securities. The term fraud as here used does not have reference to premeditated fraud alone. It includes transactions which are fraudulent in effect even though bad faith is not present. Just as much money is lost through the failure of *bona fide* but misguided business ventures as through out and out frauds. In either case the stockholder generally loses. Both should be prevented as far as possible and this was the object of the law.

"The primary question before the commission in every case is whether or not the sale of the particular security is fraudulent or will work a fraud on purchasers thereof. The commission has interpreted the law to mean that the sale of a security is fraudulent, or tends to work a fraud on the purchaser, *if the latter does not have a fair chance to gain by his investment. It is not sufficient that the money invested is secure against loss.*"

the issuance or prevent the revocation of a license. This type of act has been sustained by the supreme court.

FEDERAL LEGISLATION NECESSARY

It has seemed necessary to devote most of the space available for this article to an outline of the history and character of "blue sky" laws. In a sense they carry their own commendation to the average reader, and their own condemnation to the reader familiar with security offerings. The question of a remedy remains, both for the evil at which they are directed and for the evils which they have created. After several years of more or less intimate study of the subject, the writer has come to one quite definite conclusion. The first problem to be met and solved, in any intelligent effort to deal with the subject, is that of controlling the creation and original promotion of corporations and associations, and the solution of that problem lies with the federal government. Neither one nor forty-seven states can solve it and forty-eight states never will without federal compulsion. Although intelligent state officials with a purely local viewpoint may see no harm in circumscribing by state lines the important national business of financing our industries, and, so far as may be, those of other countries, and may hope by local administration to stamp out the national evil of fraudulent flotations, all, whose viewpoint is national, must realize that the problem cannot be met in this way.

INADEQUACY OF STATE REGULATION

The business of marketing securities is predominantly interstate and not intrastate. It is not a business done at an office or over the counter, but one in which an established house in a central city has a clientele served by agents and mail in a large territory covering several states, or, on the other hand, a band of crooks without legal domicile who wander at will and "fly by night" from one state to another. Purely intrastate transactions can be left to the wisdom of a capable state official. He may be unduly severe with one and over trustful of another local flotation. But certainly in the smaller states local flotations are of a size and character which, as a rule, can be fairly judged and controlled, at least to the extent of preventing manifest frauds. This, of course, is apart from the political principle involved.

This administrative principle, so laudable in its statement, applies to the promotion of a mining property in Mexico, a railroad in China, an automobile invention, or a franchise or contract right involving legal pitfalls, or any other enterprise, the future of which is wholly speculative, a matter of individual judgment or guesswork. If the state bureau is convinced that there is "a fair chance to gain," it goes forward; otherwise it is stopped. It was admitted in oral argument in one of the reported cases that the promotion of the Ford automobile, which was originally financed as a pure speculation and considered visionary by business men, would probably have been disapproved under these laws. The state official has many means of informing himself on particular industries. In one important state, a very excellent official was said to keep posted on one class of enterprises through a personal friend in the business who advised him, speaking of his own competitors, to "watch them all." The Minnesota or Wisconsin investor can no doubt take his chances despite these manifest dangers, but the large Minnesota or Wisconsin enterprise seeking a broader market in other states may find its development thwarted when confronted with the burden of proving its business prospects to the satisfaction, not of one but of many state commissions.

It is, however, when we apply the conception of these laws to interstate flotations, good or bad and especially bad, that we realize their failure to fulfil their purpose. With the highest respect for the state officials, it is impossible to expect many of them to be able to cope with the complications and corporate machinery of large speculative or fraudulent interstate flotations. On the other hand, the laws themselves with the necesssity of even a colorable compliance with them, are prohibitive of the normal investment interstate business. It is neither necessary nor worth the burden to include West Virginia or North Dakota or even Wisconsin or Michigan in a circular offering of new securities, and consequently the investors of those states are deprived of whatever value there may be in such offerings of investment securities. The larger New York and Chicago investment houses revise their mailing list on securities subject to the laws, while the speculative promoters and "get-rich-quick" merchants resort to various devices to evade the laws, possibly attracting inquiry by disguised news advertising and by closing transactions in a "non-blue-sky" state, or sending agents into a state to sell licensed securities or a fine grade of jewelry with a side-line, not of fake securities, but of tips on a rare opportunity to buy the same of the Bunkem Morgan Co., in Pittsburgh or Indianapolis. The states are too small and the business too large, complicated, important and profitable on speculative issues, for any hope of solution by state laws. Of course the fundamental evil lies in the laws of the corporation-making states, and it is hopeless to attempt to correct this evil by empowering the state officials of Wisconsin, Michigan and Ohio to exercise diverse judgments on the amount of stock which the state of West Virginia should permit to be issued for property in Oregon or Mexico.

FEDERAL RESTRICTION ON CORPORATE ORGANIZATION

We need a federal "blue sky" law. The constitutional difficulty must be met. A federal law reasonably adapted to the constitutional purpose of preventing fraud and deception in interstate flotations of securities would presumably be upheld. The fact should not be ignored that, although the power is to regulate interstate commerce, the jurisdiction of the federal government exercising this power extends to every part of the country. In the regulation of such commerce it may require such safeguards and preventatives as are adapted to its protection and freedom. It does not, so to speak, sit with a gun in hand on the imaginary boundary line of a state. An intrastate act injuriously affecting interstate commerce, including, it would seem, an act of the state itself creating a so-called "piratical corporate entity," designed as an instrument of interstate frauds, is within the federal jurisdiction.

If the creation and promotion of corporations under lax state laws is found to be productive of fraud in interstate commercial transactions, the creation of such corporations having power to engage in such transactions, may, it would seem, be prevented and controlled. If a corporation does not desire to engage in interstate commerce, it should not ask the power to do so. If it asks the

power to do so, it presumably intends to exercise that power. In a word, it would seem possible for the federal government by a restrictive law to condition and standardize the charters, organization and promotion of all corporations excepting those which are by their charters confined to the creating state, *i.e.*, prohibited from engaging in interstate commerce, and their securities forbidden to be sold in states other than the state of their creation. If this is so, the problem may be substantially dealt with under the federal power and from the viewpoint of controlling the original creation of and imposing the necessary limitations upon the corporation itself. The problem could then be met comprehensively and effectively, following, if desired the excellent examples already at hand in the British and Canadian Companies' Acts.

BENEFITS OF REGULATION

Solely to instance the efficiency of this method of approach, and without wishing to present any specific details —it would be possible to require the proper valuation of properties issued for stock, though permitting the issuance of stock without par value; to require a promoters' statement to be filed and published stating all the material facts entering into the promotion, including the amount necessary to carry out the professed object of the corporation; to prohibit any allotment without a complete subscription or underwriting; to require that if less than 90 per cent of the proceeds of any public offering of securities is received by the corporation, and the fact is not made known to intending purchasers, any resulting sale shall be void; to require a general stockholders' meeting, similar to the statutory meeting under the British Companies' Act, with power to rescind any action not disclosed, or based on facts not disclosed in the promoters' statement; in short, to see that the company is completely organized for an honest business—not simply for stock jobbing—before it has satisfied the conditions of its creation. Any such law should favor the honest promoter, recognizing, as Professor Mead expresses it, that he "performs an indispensable function in the community by discovering, formulating, and assembling the business propositions by whose development the wealth of society is increased."

THE PROPER BASIS FOR "BLUE SKY" LEGISLATION

It is impracticable in this article to discuss adequately the details of a proposed law.[6] But a final word should be said as to the proper conception on

[6] The Taylor Bill, now in Congress, presents perhaps the most intelligently conceived plan of enforced publicity yet proposed. In substance, it requires a statement of information to be filed at Washington on any general offering of securities, and duplicates to be filed in a proper office in each territory covered by the offering. It also requires that any dealer or underwriter offering a company's securities must join in and guarantee the company's or promoter's statement of facts. This requirement tends to defeat its purpose by driving conservative dealers from the field and removing the most responsible check to ill-advised flotations. If this feature of the bill were enacted, it might be safely predicted that its able author, counsel for the late Capital Issues Committee, would not, on full consideration, accept a partnership in the best investment house in the country, for the very simple reason that he would soon have hanging over him a contingent liability of at least one hundred times his capital. An investor can buy and hold his securities, assuming, as he does, his risks of loss, but a dealer selling many

which the law should rest. Let us first assume the formation and financing of a business or enterprise by three men, one supplying the opportunity, another the management, and a third the money. They deal with each other at arm's length and no one would suggest that a state official should intervene and revise their contract, or prohibit the enterprise because he did not think it would succeed, or because one was believed to be getting the best of the bargain. It might be said, in passing, that in this case it is usually the man with the money who dictates terms. Now this situation is altered, and radically altered, by a general solicitation or offering of securities, when the third party is the general public, or perhaps a portion of the public consisting of a carefully selected list of inexperienced and gullible investors, and when all the facilities of corporate chicanery may be used to rob them of their earnings. All agree that the state can and should take an interest in protecting this situation. Academically, at least, all agree that the corporate facilities should be safeguarded against the dangers it presents. All agree that the prospective purchasers should have all the facts which the moneyed man in the first instance gets for himself; that the solicited investor should not be permitted to "buy blindly," even if he is willing to do so. But should we go further? Should the state administrator say, "This is an unsound venture; it will 'work a fraud' on this class of investors to permit them to be solicited on such an offering; finance it privately, if you can, but you cannot finance it by a general solicitation or offering?" In the answer to this question lies the fundamental divergence of opinion among the advocates of "blue sky" legislation.

The British and Canadian acts register the answers of those governments, given after a study of the subject, which in its comprehensive thoroughness has not been remotely approached in this country. The writer, for one, is inclined to accept this viewpoint and to reject the suggestion of so drastic and impracticable an executive power, at least until the conditions on which all are agreed are met; until, first, the creation and promotion of corporations have been safeguarded at their source, and second, adequate provision has been made to give the prospective purchaser of securities the information which he needs in order to exercise his own judgment and his own freedom in investing his own money in securities. The peculiar facilities to fraud must be removed; only when that is done are

times his capital cannot assume the risks of loss on all he sells, unless he charges a heavy insurance premium. He should, and does, of course, assume responsibility for his own care in investigating the security and in recommending it to his customers. In the discussion on the bill some question has been raised as to the power of Congress over corporations having "power to engage in interstate commerce," as distinguished from corporations actually engaged in interstate commerce. Certainly, if Congress is to prevent the evil contemplated, it should not have to let the corporation first issue its stock and then engage in interstate commerce. Logically and constitutionally it should prohibit the organization of any corporation or association having power to engage in commerce "unless, in the charter or articles of association or laws governing the same," the prescribed necessary conditions and safeguards against evil are provided. For the prevention of fire, it may be necessary to forbid throwing of lighted matches in waste baskets.

we in a position to consider the need of a further remedy to protect the investor whose judgment and will are too weak to enable him to protect himself. A general law regulating necessary business transactions cannot be based on the assumption of incompetence of persons legally competent to manage their affairs.[7]

Note.—As early as 1895 a departmental committee of the British Board of Trade investigated this subject and reported *inter alia* as follows: "Your committee may observe that they have dismissed from their consideration every suggestion for a public inquiry by the registrar or other official authority, into the soundness, good faith, and prospects of the undertaking at this or any other stage of the company's formation. To make any such investigation into the position of any new company complete or effectual would demand a very numerous staff of trained officers, and lead to a great delay and expense, while an incomplete or perfunctory investigation would be worse than none. It would be an attempt to throw what ought to be the responsibility of the individual on the shoulders of the State, and would give a fictitious and unreal security to the investor, and might also lead to grave abuses."

[7] The real point involved in the idea of administrative prohibition lies in the understanding of what is to be prohibited. The original Kansas conception, still adhered to by many intelligent state officials, is that the examining board should prohibit an offering which seems to be unsound or unlikely to succeed, or where it considers the promoter's profit too great or "extortionate." A different view was expressed by former Corporation Commissioner Watson, of Oregon, in 1914, who wrote that he had "attempted to do two things—to stop fraudulent transactions and the sale of stocks through misrepresentations first, and secondly, to require that wherever a security of a speculative nature was sold the seller present the matter honestly and fairly to the intending purchaser." He was of course operating under a regulative law. He later urged the fraud provision now found in the West Virginia Act, recognizing that fraud should be penalized, not simply reproved or "stopped," by executive order. It has recently been proposed in connection with the Taylor Bill to authorize the Federal Trade Commission to "issue an order against anyone who had come under suspicion by attempting fraud or deception, which order would act as a prohibition against their doing business until they had shown to the satisfaction of the commission that their offerings were meritorious." This is a very practical viewpoint, very generally expressed. Is it politically sound? Given a statute punishing the first overt act in any scheme to defraud, and requiring advance notification of the fact and character of any proposed offering, with power of official investigation (such was the proposed fraud act mentioned in Note 2), the promoter of "fraudulent and misrepresented securities," or one "who had come under suspicion by *attempting fraud or deception,*" would find his promotion cognizable by the prosecuting attorney, and not simply by an administrative official, who upon showing that his offering was "meritorious," might license his further attempt at "fraud or deception." The objection to this governmental conception is that it shifts the responsibility for the prevention of crime to an administrative board, which by its inaction, by confidence in or friendship for individuals, by political influence, or by the always increasing accumulation of work, permits and invites the thing intended to be prevented; there is no prohibition, law or penalty until it is created by an executive fiat in the particular case. The potential criminal is safe until he is detected and then he is, or might be, told to be good. Despite the fascination of this idea for many minds and particularly for the practical man of business, who, being honest, has nothing to fear from it, its political unwisdom must be recognized by students of constitutional government. It is in a sense a continuing invitation to criminal effort, an effort to "get by" and to "put it across" before the official body wakes up; an effort, which, if successful, goes unpunished; if unsuccessful, is punished by an executive order to desist from a further flotation of securities.